Vermont State Retirement Systems
Statement of Investment Policy Guidelines
Section A - General Guidelines

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I. INTRODUCTION

The Vermont Retirement Systems were created to provide retirement allowances and other benefits for the teachers, state and municipal employees of the State of Vermont. Investments of the Vermont Retirement Systems' assets shall be made to ensure current and future benefit obligations are adequately funded in a cost-effective manner and reflect current industry practice. The preservation of capital and the achievement of sufficient total return to fund accrued and future benefit obligations are the primary concern.

This Statement of Investment Policy and Objectives is designed to clearly communicate the directives of the Trustees of the Vermont Pension Investment Committee ("VPIC") to all interested parties. It may be revised from time to time, as deemed necessary, may be annually reviewed to insure its relevance to the Fund needs, and any resulting material changes will be communicated to all affected parties. This investment policy will apply to the funds of the Systems on an aggregate basis.

II. RELEVANT LEGISLATION AND REGULATION

The Vermont Pension Investment Committee is responsible for the investment of the assets of the State Teachers' Retirement System of Vermont, the Vermont State Employees' Retirement System, and the Vermont Municipal Employees' Retirement System pursuant to section 472 of Title 16, and section 5063 of Title 24. The State Treasurer serves as the Custodian of the funds of all three systems. 3 V.S.A. §523(a).

Investments for the Vermont State Employees', Vermont Teachers' and the Vermont Municipal Employees' Retirement Systems are required to be made in accordance with the standard of care established by the prudent investor rule under chapter 147 of Title 9. Specifically, in making investments for those systems the Trustees of the Vermont Pension Investment Committee shall exercise the "reasonable care, skill, and caution" and "invest and manage trust assets as a prudent investor would, by considering the purposes, terms distribution requirements, and other circumstances of the trust." 9 V.S.A. §4652(a).

In addition, pursuant to 24 V.S.A §5062(a), investments for the Vermont Municipal Employees' Retirement System are required to be made "with judgment and care, under circumstances then prevailing, which persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of capital as well as the probable income to be derived."

Investments of the assets of the State Teachers' Retirement System of Vermont, the Vermont State Employees' Retirement System, and the Vermont Municipal Employees' Retirement System shall be made in full accordance with any and all applicable Vermont statutes, as well as any other applicable legislation or regulation, state, federal or otherwise.

III. ROLES AND RESPONSIBILITIES

The Role and Responsibilities of the Vermont Pension Investment Committee

The Vermont Pension Investment Committee ("VPIC") will review and direct the investment program. The VPIC will review and approve the investment policy and provide overall direction in the execution of the investment policy. VPIC will review and approve or disapprove investment recommendations governed by VPIC prior to their execution. VPIC will review, on a regular basis, investment results in relationship to investment expectations and actuarial assumptions and experience to determine if future changes are needed to either the Investment Policy Statement or the implementation of the Investment Policy Statement.

VPIC is responsible for developing and modifying policy objectives and guidelines, including the development of liability-driven asset allocation strategies and recommendations on long term asset allocation and the appropriate mix of investment manager styles and strategies. VPIC is the final authority in manager searches and selection, evaluation, and any other related analysis.

Additionally, VPIC provides oversight of the investment consultant and investment service providers and will communicate to the investment consultant any financial information necessary to fulfill contractual obligations.

Investment Consultant

The Investment Consultant shall assist the VPIC in developing and modifying policy objectives and guidelines, including the development of a liability-driven asset allocation strategy and recommendations on the appropriate mix of investment manager styles and strategies. The Consultant shall also assist the VPIC in monitoring investment manager compliance with such Policy Objectives and Guidelines. The Consultant shall act as a fiduciary to the Fund.

Additionally, the Consultant shall provide assistance in manager searches and selection, investment performance and diagnostic analysis, evaluation, and any other relevant studies. The Consultant shall provide timely information, written and/or oral, on investment strategies, instruments, managers and other related issues.

The Investment Consultant will promptly inform the VPIC regarding all significant matters pertaining to the investment of Fund assets.

Investment Managers

The duties and responsibilities of the investment managers retained by the Fund include:

- Investing the assets under their management in accordance with the policy guidelines and objectives expressed herein.

- Managers are expected to meet or exceed their strategy-specific benchmarks, net of all fees and expenses, over various and appropriately measured time periods.

- Exercising investment discretion within the guidelines and objectives. Such discretion includes decisions to buy, hold or sell securities in amounts and proportions compatible with the Fund's investment objectives and reflective of the manager's current investment strategy.

- Complying with all provisions pertaining to the investment manager's duties and responsibilities as a fiduciary. Fund assets should be invested with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent professional investment manager, acting in a like capacity and familiar with such matters, would use in the investment of Fund assets.

- Complying with the Global Investment Performance Standards (GIPS) Code of Ethics and Performance Presentation Standards (PPS).

- Complying with Regulation 2001-01: Standards of Conduct. (See Section C)

- Disclosing in writing all conflicts and potential conflicts of interest.

- Ensuring that all portfolio transactions are made on a "best execution" basis.

- Exercising ownership rights, where applicable, through proxy solicitations, doing so strictly for the economic benefit of the Fund and in compliance with state laws and proxy voting guidelines. The investment managers or other dedicated parties shall provide written documentation regarding the disposition of proxy solicitations on an annual basis.

- Meeting with the VPIC on an annual basis, or upon request. Quarterly reports are to be submitted in writing within 45 days after the end of each quarter.

- Acknowledging in writing to the VPIC the investment manager's intention to comply with this Statement.

- Initiating written communication with the VPIC when the manager believes that this Investment Policy is inhibiting performance and/or should be altered for any valid reason. No deviation from the guidelines and objectives established in the

Policy is permitted until after such communication has occurred and the VPIC has approved such deviation in writing.

- For separately managed accounts, managers are responsible for reconciling performance, holdings and security pricing data with the Fund's custodian bank. If the Fund's custodian bank shows a different price for a given security, the manager shall submit to the custodian bank's price reconciliation process. Managers shall provide a summary of reconciled holdings both in hard copy and electronic format on a monthly basis.

Custodian Bank

In order to maximize investment return, no monies shall be allowed to remain uninvested. Dividends, interest, proceeds from sales, new contributions and all other monies are to be invested or reinvested promptly. The Custodian(s) will be responsible for performing the following functions:

- Accept instructions from designated investment staff
- Advise designated investment staff of additions or withdrawals from account assets
- Notify investment managers of proxies, tenders, rights, fractional shares or other dispositions of holdings
- Resolve any problems that investment staff may have relating to the custodial account
- Safekeeping of securities
- Interest and dividend collections
- Daily cash sweep of idle principal and income cash balances
- Processing of all investment manager transactions
- Collection of proceeds from maturing securities
- Disbursement of all income or principal cash balances as directed
- Providing monthly statements by investment managers' accounts and a consolidated statement of all assets.
- Providing a dedicated account representative and back up to assist in all needs relating to the custody and accountability of the Fund's assets.

- Managing the securities lending program, if applicable.
- Reconciling returns with the Fund's Investment Managers.
- Monitor arbitration and class action litigation and file proper documentation on the system's behalf when warranted.
- The custodian or affiliate will provide transition management services as contractually specified.

IV: INVESTMENT OBJECTIVES

VPIC seeks to maintain the annual rate of pension contributions based on accepted actuarial practices, at a stable or declining percent of payroll. VPIC also seeks to maintain the funded ratio (actuarial value of assets earned to date as measured by the Accrued Benefit Obligation) at a target level of not less than 100% in any given year. The Systems will adopt investment policies to ensure that they remain capable of paying all benefits required by law.

Nominal Return Requirements

Total return, which includes realized and unrealized gains, plus income less expenses, is the primary goal of the Vermont State Retirement Systems. The investment program shall be structured to preserve and enhance principal over the long term, in both real and nominal terms. For this purpose, short-term fluctuations in values will be considered secondary to long-term investment results. Moreover, the investments of the Fund shall be diversified to minimize the risk of significant losses unless it is clearly prudent not to do so.

The actuarially assumed total rate of return is determined independently by the three Funds. The total return target for Teachers' and Employees' is 8.25% and the total return target for Municipal is 8.0%.

Real Return Requirements

The VPIC is aware that inflation will erode the purchasing power of the Fund's assets; therefore a real return requirement has also been established. As the Consumer Price Index (CPI) is the most commonly accepted measure of inflation, the VPIC has defined its real return target as the nominal return less CPI. The real target rate of return over a complete market cycle is 5%.

Relative Return Requirements

The total return goal for the Vermont State Retirement Systems shall be to rank in the top half of the ICC (Independent Consultants Cooperative) public fund universe on a risk-adjusted basis. Fund returns should, over time, exceed the Policy and Allocation Indices, defined below. Returns for investment managers shall seek to exceed their respective benchmarks, as well as rank in the top half of the appropriate universe of managers adhering to the same investment strategy.

VPIC further recognizes that the return targets described herein may not be achieved in any single year. Instead, a longer-term horizon of 3-7 years or a complete market cycle shall be used in measuring the long-term success of the total Fund. While VPIC expects that returns will vary over time, the Fund shall have a risk tolerance consistent with its actuarial funded ratio and that of other funds created for similar purposes, and the assets of the Fund shall be invested accordingly.

V. ASSET ALLOCATION (see Appendix D)

This guideline is to be pursued by the Vermont State Retirement Systems on a long-term basis, but will be revised if significant changes occur within the economic and/or capital market environments. A change in liability structure, funded status, market or economic conditions may trigger a revision of this asset allocation.

Rebalancing

VPIC, or its designee, will review actual manager asset balances for each System regularly to determine if the asset allocations are consistent with the exposure ranges described herein. Investment managers and the custodian will be directed to transfer funds to rebalance the assets under management as necessary. Manager account balances must be updated monthly to ensure that asset transfers may be made on an orderly basis and without disruption of a manager’s investment activities.

Fund assets will routinely be re-balanced on a semi-annual basis, at or about the later half of March and September, each year. Except in the case of real estate, anticipated cash flow needs will be provided to the managers at least 10 days in advance.

The VPIC will strive to maintain a neutral bias with respect to Style Allocation (Growth versus Value) in its domestic equity investments. The VPIC recognizes that over the long run, returns from Growth and Value investing tend to approximate each other; over shorter periods, however, returns between the two can be significantly different.

While using discretion, and as part of the normal rebalancing process, consideration of market conditions and transaction costs, as well as any other relevant factors, will be used.

VI. MANAGER SELECTION

Initiation of RFIs, RFQs and/or RFPs require advance authorization of the VPIC with bidder qualifications determined by the VPIC, considering advice from the investment consultant, at the time of authorization. Bidder qualifications may include, but are not limited to:

- Length of firm history
- Tenure of key professionals
- Appropriateness of investment philosophy and process
- Fit between product and existing plan assets, liabilities and objectives
- Absolute and relative returns, and variability of returns
- Stability of the firm's client base and assets under management
- Ownership structure
- Compensation structure
- Fee structure

The Investment Consultant may be directed to coordinate and summarize the findings of a search. The VPIC shall be responsible for reviewing the qualified vendor responses in consultation with the investment consultant and Treasurer's office staff as appropriate.

Interviewing finalists and manager selection will be conducted by the VPIC along with approving contracting criteria.

RFI, RFQ and/or RFP materials shall be available to all VPIC members upon request.

VII. INVESTMENT MANAGER GUIDELINES

Introduction

Full discretion, within the parameters of the guidelines attached hereto, is granted to the investment managers regarding the selection of securities, and the timing of transactions.

Compliance with all guidelines must be monitored by the investment managers on an on-going basis based on current market values. Securities that, at purchase, would move the portfolio out of compliance with these guidelines, based on the investment manager's most recent valuation, may not be purchased.

In the event that a portfolio moves out of compliance with these guidelines (as identified in the investment manager's regular review of the portfolio), through market conditions or other changes outside the control of the manager, the manager must notify VPIC immediately and inform VPIC how the portfolio will be brought back into compliance within a timely manner or may request permission from VPIC to hold the investment for a longer period.

See Appendix B for Manager Specific Guidelines

General Guidelines

For managers not participating in an Alternative Investments or Real Estate program, the following guidelines are to be adhered to, unless prior approval from VPIC has been granted or use is authorized elsewhere herein

- There shall be no use of commodities without the prior approval of VPIC.
- Uncovered options or futures contracts may not be purchased.
- Short selling is not permitted.
- There shall be no use of financial leverage (for financial assets only)
- Investment managers are prohibited from directly purchasing the securities of companies whose primary source of revenue stems from the production and sale of tobacco products. This policy applies to all types of securities and to all issuers. Managers may invest in collective investment vehicles (e.g. mutual funds) that may own tobacco company securities. If it is in the best interest of the Fund to do so and there is no other viable alternative.
- Pursuant to Section 3(a) of Public Act No.13 of the Vermont General Assembly (1999 Sess.), managers holding voting shares in companies doing business with the government of Burma shall vote in favor of "shareholder resolutions filed by shareholders when those resolutions raise concerns about doing business in Burma, including requests: (1) to report on company activities in Burma; (2) to report on the full costs of doing business in Burma; (3) to address human rights or drug trafficking conditions in Burma; or (4) to establish human rights guidelines."

  Managers may invest in collective investment vehicles (e.g. mutual funds) that may own securities in companies during business in Burma if it is in the best interest of the Fund to do so and there is no other viable alternative. See "Guidelines for Use of Pooled Funds" below.

- MacBride (Northern Ireland) – Pursuant to Act No. 50 of the Vermont General Assembly (1989 Sess), managers shall provide the VPIC with a list of the corporations that directly, or through a subsidiary, do business in Northern Ireland and in whose stock the System has invested and shall advise the VPIC whether each corporation has achieved the goals known as the MacBride principles. Managers holding shares in said corporations shall at every reasonable opportunity support shareholder resolutions designed to encourage United States corporations doing business in Northern Ireland in which System funds are invested to adopt and implement the MacBride principles.

- For all investment managers across all asset classes, trades must be done on a "best-execution" basis.

Guidelines for Use of Pooled Funds

- Mutual funds, collective trusts and other types of commingled investment vehicles provide, under some circumstances, lower costs and better diversification than can be obtained with a separately managed fund pursuing the same investment objectives. However, commingled investment funds cannot customize investment policies and guidelines to the specific needs of individual clients. If appropriate, the VPIC is willing to accept the policies of such funds in order to achieve the lower costs and diversification benefits of commingled funds.

Derivatives Guidelines

This derivatives policy statement identifies and allows common derivative investments and strategies, which are consistent with applicable law and the Investment Policy Statement and requires investment managers to petition for the inclusion of additional derivative instruments and strategies. These guidelines also require investment managers to follow certain controls, documentation and risk management procedures. For managers not participating in an Alternative Investments (Private Equity, Venture Capital, Timber or Hedge Funds) or Real Estate program, the following derivative guidelines are to be adhered to, unless prior approval from the VPIC has been granted:

Definition and Classification of Derivatives

A derivative is a security or contractual agreement that derives its value from some underlying security, commodity, currency, or index. These guidelines address two classes of derivative instruments: derivative contracts and derivative securities:

1) Derivative Contracts

- Forward-based derivatives, including forward contracts, futures contracts, swaps, and similar instruments.

- Option-based derivatives, including put options, call options, interest rate caps and floors, and similar instruments.

2) Derivative Securities

- Collateralized Mortgage Obligations (CMOs)
- Other Structured Notes

Allowed Uses of Derivatives

1) Derivative Contracts

Hedging. To the extent that the non-derivative component of a portfolio is exposed to clearly defined risks and derivative contracts exist that can be used to reduce those risks, investment managers are permitted to use such derivatives for hedging purposes, including cross-hedging of currency exposures, subject to the documentation requirements listed later.

Creation of Market Exposures. Investment managers are permitted to use derivatives to gain exposure to assets and asset classes if such exposure would be allowed if created with the underlying assets.

Management of Country and Asset Allocation Exposure. Managers charged with tactically changing the exposure of their portfolio to different countries and/or asset classes are permitted to use derivative contracts for this purpose.

2) Derivative Securities

“Plain Vanilla” CMOs: For the purpose of this policy, a “plain vanilla” CMO is defined as one which can be shown that the CMO is less exposed to interest rate or prepayment risk than the underlying collateral
Other CMOs: CMOs that are not plain vanilla are restricted to 20% of a manager’s portfolio.

Prohibited Uses of Derivatives

Any use of derivatives not listed above is prohibited without written approval from the VPIC. Investment managers are encouraged to solicit such approval if they believe the list of allowable derivative instruments is too restrictive. By way of amplification, it is noted that the following uses of derivatives are prohibited:

> **Leverage.** Derivatives shall not be used to magnify a portfolio's exposure to an asset, asset class, interest rate, or any other financial variable beyond which would be allowed by a portfolio's investment guidelines if derivatives were not used.
>
> **Unrelated Speculation.** Derivatives shall not be used to create exposures to securities, currencies, indices, or any other financial variable, unless such exposures would be allowed by a portfolio's investment guidelines if created with non-derivative securities.

Transaction Risk Control Procedures and Documentation Requirements

For each over-the-counter derivative transaction, except foreign exchange forward contracts, investment managers are required to obtain at least two competitive bids or offers.

For all derivatives transactions, investment managers should maintain appropriate records to support that all derivative contracts used are employed for allowed strategies. In addition, the following requirements apply to derivative securities:

> **"Plain Vanilla" CMOs:** Document that the CMO is in fact "plain vanilla".
>
> **Other CMOs:** These CMOs must be stress tested to estimate how their value and duration will change with extreme changes in interest rates. An extreme change is one of at least 300 basis points.
>
> **Structured Notes:** Document that the note does not create exposures that would not be allowed if created without derivatives.

Portfolio-Level Risk Control Procedures and Documentation Requirements

> **Counterparty Credit Risk:** Managers are required to measure and monitor exposure to counterparty credit risk. All counterparties must have

commercial paper credit ratings of at least A1 by Standard and Poor's, or equivalent rating.

Ongoing Monitoring of Risk Exposures: The duration and other risk exposure limits specified in the managers' guidelines are expected to be satisfied on an ongoing basis. Thus, managers must monitor changing risk exposures. Fixed income managers investing in CMOs should pay particular attention to the changing duration of their CMOs, and should anticipate potential changes in duration at the time CMOs are purchased. This is to ensure that interest rate and prepayment rate changes do not inadvertently move the portfolio out of compliance.

Valuation of Holdings: The investment managers and custodian shall provide the VPIC with their pricing policies including a list of sources used. The VPIC should be notified of any exceptions to these policies. For derivative securities, the custodian is required to obtain two independent prices, or to notify the VPIC that two independent prices are not available. Investment managers are required to reconcile the valuations of all derivatives positions on a monthly basis with the custodian as governed by the Investment Policy Statement and not less than quarterly.

Domestic Active Equity Manager Guidelines

The guidelines listed below shall apply to all actively managed domestic equity portfolios, unless otherwise specifically noted:

- Domestic equity purchases are limited to publicly traded common stocks in the United States. The VPIC shall approve exceptions in advance.
- No single holding shall account for more than 6% of the allowable equity portion of the portfolio at market value, or 120% of a stock's weighting in the style benchmark against which the manager is measured, whichever is larger.
- All domestic equity portfolios are expected to be fully invested. No more than 10% of a manager's domestic equity portfolio may consist of cash or cash equivalents.
- No single holding in any manager's portfolio shall account for more than 5% of the outstanding common stock of any one corporation. Additionally, no single holding across all actively managed portfolios of an investment management firm shall account for more than 10% of the outstanding common stock of any one corporation.

- The purchase of stocks, convertibles or ADR’s (American Depository Receipts) in foreign companies which are publicly traded securities may be held by each domestic stock manager in proportions which each manager shall deem appropriate, up to 10% of the portfolio at market value.

- Convertible bonds, warrants and rights may be purchased as equity substitutes so long as they meet the equity guidelines listed above.

- Convertible preferred stocks are tax-advantaged issues, and typically would not be held in an equity portfolio; however, if pricing anomalies exist to the extent that these issues are attractive, they may be held subject to the restrictions listed above.

- 144A Privates (non-registered equity issued by corporations) are limited to 10% of the book value of the portfolio.

International Equity Manager Guidelines

The guidelines listed below shall apply to all international equity portfolios, unless otherwise specifically noted:

- Short-term reserves may be held in U.S. dollar denominated, local currency securities, or investment vehicles available through the System's custodian.

- Managers may purchase or sell currency on a spot basis to accommodate securities settlements.

- Managers may enter into forward exchange contracts on currency provided that use of such contracts is designed to dampen portfolio volatility or to facilitate the settlement of securities transactions.

- All international equity portfolios are expected to be fully invested. No more than 10% of a manager’s portfolio may consist of cash or cash equivalents.

- International equity securities generally shall be common or preferred stocks publicly traded on an international exchange. ADR’s and GDR’s are also permitted, if the underlying instrument would be properly held in the portfolio. Convertible securities, warrants and rights resulting from a corporate action are also permissible.

- Equity securities should be issued by non-U.S. corporations, although the manager has latitude to hold U.S. securities provided that such investment is consistent with attainment of the portfolio's investment objectives and does not exceed 10% of the portfolio's market value. ADR's and GDR's do not count towards this 10% limitation.

- The number of issues held and their geographic or industry distribution shall be left to the investment manager provided that equity holdings in any one company (including common stock and convertible securities) do not exceed 6% of the market value of the manager's portion of the Fund's portfolio, or 120% of a stock's weighting in the style benchmark against which the manager is measured, whichever is larger. Additionally, bonds of the companies in question would be included in the exposure calculation if held in the manager's portfolio.

- Managers with established international equity mandates may invest up to 10% of their portfolio(s) in the emerging markets.

- Managers with specific emerging markets equity mandates are expected to invest in the emerging (non-established) markets, subject to the guidelines listed above.

- 144A Privates (non-registered equity issued by corporations) are limited to 10% of the book value of the portfolio.

Domestic Fixed Income Managers

The guidelines listed below shall apply to all domestic core fixed income portfolios, unless otherwise specifically noted:

- Domestic fixed income investments may include U.S. Government and Federal Agency obligations, corporate bonds, debentures, commercial paper, certificates of deposit, Yankee bonds, mortgage-backed securities and other domestically issued fixed income instruments deemed prudent by the investment managers.

- No more than 5% of the market value of a portfolio's domestic fixed income assets may be invested in the debt securities of any one issuer. No limitations on issues and issuers shall apply to obligations of U.S. Government and Federal Agencies.

- No more than 6% of any issue shall be held by any one manager at the portfolio level (market value). Managers may hold up to 10% of a given company issue across all of their portfolios.

- The minimum quality rating of any fixed income issue purchased or held in a portfolio shall be Baa (all gradations), as rated by Moody's or an equivalent rating agency, and the overall weighted average quality of each fixed income portfolio shall be Aa (all gradations) or better.

- In the event of split rating, the highest rating shall apply. If a manager owns a bond that is downgraded below these levels, the manager must notify the system immediately of the downgrade. The manager will inform the VPIC how the portfolio will be brought back into compliance in a timely manner or may request permission from the VPIC to hold the bond for a longer period of time

- The diversification of securities by maturity, quality, sector, coupon and geography is the responsibility of the manager subject to the guidelines herein. Active bond management is encouraged, as deemed appropriate by the investment managers.

- The average duration (interest rate sensitivity) of an actively managed portfolio shall not differ from the passive benchmark's duration by more than 25 percent.

- Any mortgage-backed securities (MBS) shall be subject to the constraints listed below.

    - Agency fixed and floating rate pass-throughs, U.S. Treasury securities and cash equivalents can be held without limitation.

    - Fixed rate PAC I (Planned Amortization Class), PAC II and Sequential Collateralized Mortgage Obligations can be held without limitation.

    - Inverse floating rate, interest only (I/O), principal only (P/O), and accrual CMOs in aggregate will be limited to 15% of the mortgage securities portfolio, with no more than 5% of the portfolio invested in accrual CMOs. In the event that other types of mortgage-related securities that have risk characteristics similar to those in this category are developed, the manager will inform the investment committee of those securities and they will be included in this 15% limitation.

    - All other types of mortgage-related securities not explicitly cited herein will be limited to an aggregate 20% of the portfolio.

    - The manager must receive at least two competitive offers on the same or similar securities prior to purchasing each mortgage-backed security for the portfolio.

- The VPIC recognizes that the calculation of the duration of a mortgage-backed security involves assumptions as to the expected future prepayment rate for the security at the time of calculation and that prepayment rates cannot be precisely determined in advance. The manager should calculate expected duration prior to the initial purchase of a security and on a routine basis in monitoring the portfolio's compliance with these guidelines.

- 144A Privates (non-registered debt issued by corporations) rated Baa or better by Moody's Investors Services, Standard and Poor's, or Fitch Investor's Services and non-convertible preferred stock are limited to 10% book value of the portfolio.

Core Plus Fixed Income Managers

In addition to the language included under Domestic Fixed Income Managers, the guidelines listed below shall apply to all core plus fixed income portfolios, unless otherwise specifically noted:

- Domestic fixed income investments will also include U.S. dollar denominated debt of non-US issuers including: corporate, sovereign, supranationals; foreign agency and foreign local government entities (including Emerging Market Debt).

- At least eighty percent of the portfolio shall be invested in fixed-income securities with an average quality rating of A as rated by Moody's, Standard & Poor's or Fitch at the time of purchase.

- Up to twenty percent of the portfolio at the time of purchase may be invested in securities with a quality rating of below investment grade (BB to CCC) or may be unrated, if deemed to be of suitable quality for the portfolio. If a security is downgraded subsequent to purchase or a market movement causes the portfolio's holdings of below investment grade securities to exceed this limit, a sale is not mandated. The higher of the Moody's, Standard & Poor's, and Fitch ratings shall be used to determine compliance with quality guidelines.

- 144A Privates (non-registered debt issued by corporations) rated Baa or better by Moody's Investors Services, Standard and Poor's, or Fitch Investor's Services and non-convertible preferred stock are limited to 15% (domestic fixed income managers is limited to 10%) book value of the portfolio.

- A maximum of 15% of the account can be invested in non-US dollar denominated bonds. However, including aggregate currency exposure, no more than 5% of the account shall be invested in non-US currencies (unhedged).

High Yield Fixed Income

The guidelines below shall apply to all domestic high yield portfolios, unless otherwise specifically noted. The manager is granted full discretion within the guidelines described herein:

- The manager is expected to invest in fixed income securities which may include: fixed rate corporate debt securities, zero coupon bonds, step-up bonds, deferred coupon bonds, callable bonds, medium term notes and other domestically issued fixed income instruments deemed prudent by the investment manager.

- Non-rated issues may comprise up to 10% of each portfolio, provided that the manager determines that, if such an issue were rated, it would be allowed under the guidelines listed above.

- No more than 10% of the portfolio may be invested in bonds issued by foreign entities.

- No investments should be made in private placements, except for marketable securities issued under Rule 144A.

- The manager may not invest in the following: emerging market bonds, securities that are not denominated in U.S. dollars, equity shares (other than preferred stock or holdings received via an attachment to bond investments), warrants (other than preferred stock or holdings received via an attachment to bond investments), venture capital investments or in partnerships.

- The manager should seek to achieve its investment objective primarily through investment in high yield corporate securities, however, the manager may invest up to 20% of its net asset in investment grade securities at their discretion if market conditions warrant.

- The manager may buy or sell, to a limited extent, derivative instruments (such as futures, options, and swaps) to use as a substitute for a purchase or sale of a position in the underlying asset and / or as part of a strategy designed to reduce exposure to other risks, such as interest rate risk. In no event may derivative securities be used to leverage the Account.

- The manager may not sell securities short, buy securities on margin, borrow money or pledge assets, nor buy or sell commodities or currencies within the Account.

- No bonds may be purchased that have a credit rating less than “B” at the time of purchase. Split rated securities are permitted, provided they are rated at least “BB or B” by one of the 3 major ratings agencies (S&P, Moody’s, and Fitch).

- Securities that are downgraded, such that the ratings by Moody’s, Fitch, and S&P are below the minimum allowable security quality of “B”, may be held at the manager’s discretion. In such an event, the Manager will inform the VPIC how the portfolio will be brought back into compliance in a timely manner or may request permission from the VPIC to hold the bond for a longer period of time.

- The maximum industry weight of the Account should not exceed 3 times the industry weight of the Merrill Lynch High Yield Master II index and the maximum position size for an issuer should not exceed 3% of the Account.

- The diversification of securities by maturity, quality, sector, coupon, and geography, except as constrained above, is the responsibility of the manager.

- The manager is expected to be fully invested; this notwithstanding, the VPIC understands that some liquidity in the portfolio is necessary to facilitate trading, and does not place an explicit restriction on the holding of cash equivalents. The custodian bank STIF is an allowed investment, as are other cash equivalents.

- Responsibility for the exercise of ownership rights is delegated to the manager.

Global Fixed Income Managers

The guidelines listed below shall apply to all global fixed income portfolios, unless otherwise specifically noted:

- The global bond portfolio may hold no more than 30% of its assets, at market value, or 120% of each country’s benchmark weight (whichever is greater) in the debt securities of any single foreign government or non-U.S.

government entity. For the purposes of this calculation, all countries within the European Single Currency shall count as one country. No single non-government debt security shall constitute more than 6% of the global bond portfolio, at market value. Securities issued by AAA Rated Supranational Organizations (such as the World Bank) shall be considered to be government equivalents.

- Short-term reserves may be held in U.S. dollar denominated or local currency securities or investment vehicles available through the Fund's custodian.

- The minimum quality rating of any fixed income issue purchased or held in a portfolio shall be Baa (all gradations), as rated by Moody's or an equivalent rating agency, and the overall weighted average quality of each fixed income portfolio shall be Aa (all gradations) or better.

- In the event of split rating, the highest rating shall apply. If a manager owns a bond that is downgraded below these levels, the manager must notify the VPIC immediately of the downgrade. The manager will inform the VPIC how the portfolio will be brought back into compliance in a timely manner or may request permission from the VPIC to hold the bond for a longer period.

- Managers may enter into forward exchange contracts on currency provided that use of such contracts is designed to dampen portfolio volatility rather than lever portfolio risk exposure beyond those limited in this document. Opportunistic currency positioning may be utilized to hedge and cross hedge the portfolio's currency risk exposure or in the settlement of securities transactions. The manager may vary the total portfolio's exposure to currency from fully unhedged to fully hedged.

- Managers may purchase or sell currency on a spot basis to accommodate securities settlements.

- Decisions as to the number of issues held and their geographic distribution shall be the responsibility of the investment manager, subject to the percentage limitations noted above.

- Emerging Market Debt securities may be utilized as long as they comply with the overall Policy Guidelines.

- The average duration (interest rate sensitivity) of a global fixed income portfolio shall not differ from the passive benchmark by more than 25 percent.

Real Estate Investment Managers

The Guidelines below shall apply to all real estate portfolios, unless otherwise noted below:

- Real estate assets are defined as those investments, which are unleveraged or leveraged private equity positions in real property. Real estate investments are included in the Vermont portfolio in order to reduce year-to-year volatility without significantly reducing overall expected real return.

- The Real Estate Investment Program utilizes discretionary commingled fund investment vehicles that are sponsored by real estate Investment Managers. It is an objective of the VPIC to encourage the minimum number of manager relationships necessary to prudently diversify associated manager risk while seeking to maximize fund efficiency.

- Program Control And Monitoring – All managers are required to adhere to contractual agreements as approved by the VPIC. Specific guidelines are determined by the approved vehicle and its legal requirements which must be reviewed and approved during a complete due diligence. At a minimum, each vehicle must provide quarterly reporting consistent with the requirements of the VPIC.

Alternative Asset Managers

The guidelines listed below shall apply to all Alternative portfolios, unless otherwise noted:

- The Vermont State Retirement Systems may endeavor to systematically commit additional funds to this asset class, private equity, timber and other types of venture capital, over time as it becomes under-represented relative to the Vermont State Retirement Systems' target asset allocation, or as appropriate opportunities become available.

- Alternative asset amounts that are in excess of the target amount as a result of partial or full liquidation of positions or the receipt of income from investments, shall be reallocated to the Vermont State Retirement Systems' under-allocated asset classes. Liquidations should be re-invested in the alternative asset program if that asset class is under-represented relative to the Vermont State Retirement System's target asset allocation.

- The Vermont State Retirement Systems shall only invest in alternative assets when there is complete transparency and policy compliance reporting. The

VPIC recognizes that alternative assets are potentially more risky than other investments of the Fund.

- The Vermont State Retirement System's initial investment in a partnership/fund shall not exceed 10% of the committed capital of that partnership/fund.

- All investments must have a mechanism for exit.

- No more than 25% of the alternative asset investment allocation may be invested with a single manager, general partner, or single fund, with the exception of a fund-of-funds.

- Preference will be given to those funds where the general partner is contributing at least 1% of total fund.

- References on a general partner must be checked prior to investing in a fund.

Global Asset Allocation (GAA)

The Guidelines below shall apply to all global asset allocation (GAA) portfolios, unless otherwise noted below:

- The underlying investment in these strategies may include a wide range of asset classes which will include all the asset classes previously detailed in the General Guidelines section of this document. Furthermore, Commodities, REITS and short positions can be included.

- The sum of all asset class exposure included in a GAA mandate will equal 100% (No leverage).

- Within asset classes, covered short positions in individual markets are permitted subject to the limitations discussed in the two bullets above.

- All sub asset classes must abide by all existing asset class guidelines previously specified in this document.

Portable Alpha

The Guidelines below shall apply to all portable alpha mandates, unless otherwise noted below:

- The underlying investment in the beta source can include the use of derivatives.

- The underlying investment in the alpha source may include all the asset classes otherwise detailed in the General Guidelines section of this document.

VIII. INVESTMENT MANAGER MONITORING

General Guidelines

In-house meetings with investment managers, for the purpose of reviewing performance, will be conducted by the VPIC, in cooperation with the investment consultant and staff of the Treasurer's Office. In-person interviews with investment managers will be held at least annually, or more frequently as necessary. Meetings with investment managers are open meetings and open to all VPIC members, and all VPIC members will be notified of meetings in advance.

The investment consultant will present a comprehensive investment performance review for all managers, as well as for the systems as a whole, to the VPIC on a quarterly basis, in writing and in person.

The VPIC shall monitor and evaluate manager performance using the following resources:

- Quarterly Investment Performance and Portfolio Analysis

- Other analyses as needed

- Portfolios shall be measured over various and appropriate time periods.

- The VPIC may consider multiple factors influencing manager performance, and attempt to discern market cyclicality from manager over/underperformance.

- On a regular basis, the VPIC will review actual investment results achieved by each manager (with a perspective toward a three to five-year time horizon or a peak-to-peak or trough-to-trough market cycle) to determine whether the investment managers performed satisfactorily when compared with the objectives set and in relation to other similarly managed funds.

- The VPIC will re-evaluate, from time to time, its progress in achieving the total fund, equity, fixed income, and international equity segments objectives previously outlined.

- The periodic re-evaluation will also involve an assessment of the continued appropriateness of: (1) the manager structure; (2) the allocation of assets among the managers; and (3) the investment objectives for the Fund's assets.

- The VPIC may appoint investment consultants to assist in the ongoing evaluation process. The consultant(s) selected by the VPIC is expected to be familiar with the investment practices of similar retirement plans and will be responsible for suggesting appropriate changes in the Fund's investment program over time.

Manager Probation

Investment managers may be placed on a watch list in response to the VPIC's concerns about the manager's recent or long-term investment results, failure of the investment advisor to comply with any of these investment guidelines, significant changes in the investment advisor's firm, changes in the manager's investment strategy, anticipated changes in the Fund structure, or any other reasons which the VPIC deems appropriate.

Attainment of investment objectives does not guarantee continued employment by the VPIC nor does failure to achieve these guidelines ensure dismissal. Managers serve at the discretion of the VPIC.

Performance Benchmarks

Total Fund Return: The Total Fund return shall be compared against other public pension plans. The Vermont State Retirement Systems shall seek to compare its returns against other funds of similar size and circumstances. The Total Fund return shall seek to meet or exceed the Policy Index return and the Allocation Index return, which are each described below.

Policy Index: The Policy Index return shall measure the success of the Fund's target allocation. It shall be calculated by using index rates of return for each asset class invested in by the Fund multiplied by the percent targeted to each asset class.

Allocation Index: The Allocation Index return shall measure the success of the Fund's current allocation. It shall be calculated by using index rates of return for each asset class invested in by the Fund multiplied by the actual percent allocated to each asset class. The difference between the Allocation Index return and the Policy Index return measures the effects of deviating from the target allocation. If the Allocation Index return is greater than the Policy Index return, then deviating from the target allocation has added value. If the Allocation Index return is less than the Policy Index return, then active management has not added value.

The difference between the Allocation Index return and the Total Fund return measures the effect of active management. If the Total Fund return is greater than the Allocation Index return, then active management has in aggregate added value. If the Total Fund return equals or is less than the Allocation Index return then active management has not added value.

Manager Benchmarks: The Investment Managers shall be compared to a combination of passively managed index returns matching the managers' specific investment styles, as well as the median manager in their appropriate peer group universe.

IX. MANAGER REPORTING REQUIREMENTS

Policy Compliance

Managers are expected to adhere to the following guidelines. Managers must request, in writing, deviations from these guidelines. If no permission is granted, managers must not take any action that would, at the time of the action, move their portfolio out of compliance with these guidelines. Managers must acknowledge in writing to the VPIC and Investment Consultant the Investment Manager's intention to comply with this policy.

Managers must disclose to the VPIC and Investment Consultant any deviation from or violation of the Investment Guidelines described herein as soon as the manager is aware the policy has not been fully complied with. The timing, duration, and resolution to any policy violation must be disclosed.

Managers must promptly inform the VPIC and Investment Consultant of all significant matters pertaining to the investment of Fund assets, for example:

- Changes in investment strategy, portfolio structure and material market value changes of managed assets.
- Timely notice of significant events, ownership affiliations, organizational structure, financial condition, professional personnel staffing and clientele of the investment management organization within the manager's investment mandated Quarterly summary.
- Any material changes in the liquidity of the securities they hold in their portfolio.

Managers shall initiate written communication with the VPIC and Investment Consultant when the Investment Manager believes that this Investment Policy is inhibiting and/or should be altered. No deviation from these guidelines is permitted until after such communication has occurred and the VPIC has approved such a deviation in writing.

In addition, Investment Managers shall supply a written quarterly summary of the following:

- Guideline compliance.
- Brief review of investment process.
- Discussion of any changes to the investment process.
- Investment strategy used over the past year and underlying rationale.
- Evaluation of strategy's success/disappointments.
- Comment on the manager’s assessment of the current liquidity of the portfolio and the market(s) in which the portfolio is invested. For managers holding mortgage-backed securities, results of current ‘stress’ tests on the portfolio, indicating how the manager believes it would respond to interest rate movements of plus or minus 100, 200, and 300 basis points from current levels are required.

This format is to be used for annual presentation to the VPIC.

Performance Review

The following quarterly reporting requirements shall apply to all managers:

- Provide total fund and asset class returns for last quarter, year-to-date, last year, three years and five years, and since inception versus designated benchmarks. All performance data shall be in compliance with AIMR Performance Presentation Standards (PPS™).
- Discuss performance relative to benchmarks.
- Provide portfolio characteristics relative to benchmark.

When scheduled to make a presentation before the VPIC, managers will comply with the following suggested minimum content/format:

- Names of presenters (on cover)
- Account asset growth in dollar terms – contributions and withdrawals

- Staff/organizational chart: list names of key individuals
- Sector allocation/country: % exposure vs. target index
- Performance
  - Quarter
  - Year to date
  - 1,3,5 year (average annualized)
  - Since inception
- What helped and what hurt: sector or security selection attribution
- Outlook for future: (i.e. overweight sectors, industries, economic trends, etc.)
- Portfolio holdings.

Derivatives Review

The following quarterly reporting requirements shall apply to all separately managed portfolios:

- A list of all derivative positions as of quarter-end.

- An assessment of how the derivative positions affect the risk exposures of the total portfolio.

- An explanation of any significant pricing discrepancies between the manager and custodian bank.

- An explanation of any non-compliance

- For commingled funds, a list of derivative positions and assessment of the effect on the risk exposure of the portfolio.

Portfolio Holdings

The following quarterly reporting requirements shall apply to all managers:

- Present book value and current market value for all securities or real estate investments held.

- List individual securities by:

  - Appropriate sectors for domestic equities

  - Country and by industry within country for international equities

  - Sector for domestic fixed income

  - Property type and geographic region for real estate

Commissions/Trading Report

Each manager shall provide an annual commission report to be delivered to the VPIC and Investment Consultant within forty-five (45) days of the end of each calendar year [December 31]. The report shall cover all trades executed during the prior calendar year. Each annual commission report should include the following:

Broker Selection Policy: Discussion of the firm's policy for selecting brokers, reviewing brokers, and negotiating brokerage commissions. This should include identification of any situations where the investment manager has a financial interest in brokers used to execute trades in the portfolio as well as a list of all broker-dealers used by the firm.

Commission Expense: Provide a review of the portfolio's actual commission expenses over the prior year. At minimum, this should be broken down by broker and include a distinction between commissions (including spreads) on listed versus unlisted securities, average commission per share, total shares traded, total commission expense, and total trading volume.

Transaction Cost Analysis: If the firm has a system for monitoring total transaction costs, commissions plus market impact, a copy of this analysis should be provided. If no such system is being used, the commission report should include complete explanation of how the firm monitors selected brokers for best execution.

Soft Dollar Report

Each manager shall complete an annual soft dollar report to be delivered to the VPIC and Investment Consultant within forty-five (45) days of the end of each calendar year [December 31]. The report shall include the following:

- A discussion of the firm's soft dollar policy, including how the investment manager ensures its clients of full disclosure, record keeping, and consistency of soft dollar information.
- A discussion on how the investment manager determines that a service can be paid with soft dollars and how the investment manager allocates mixed-use research (services that are not 100% used in the investment decision-making process). If less than 100% of the research and/or services are used in the investment decision-making process, the Investment Manager should pay only for the portion attributed to assisting in the investment decision-making process.
- A discussion of the procedures in place to assure that any research and/or services purchased by the firm with soft dollars are used for the benefit of the Vermont State Retirement Systems plan participants.

- A listing of all soft dollar brokers and their payout ratios.

- A report identifying any goods and services, including proprietary research purchased by the manager with soft dollars over the past year. This should include soft dollars generated by agency and principal transactions. This report should provide, at a minimum, the cost and description of the goods and services purchased.

- Verification that the Fund's percentage of commissions paid to soft dollar brokers is less than or equal to the Fund's percentage of the total of similarly managed assets of the investment manager.

Ethics Report

Managers shall annually report to the VPIC, standing policies with respect to ethics and professional practice, within forty five (45) days of the end of the of each calendar year [December 31].

- Managers shall annually report to the VPIC compliance with the Association of Investment Management and Research (AIMR) Code of Ethics. Managers shall disclose if they are made aware of any Chartered Financial Analyst (CFA) charter holders employed by their firm that have been publicly censured by AIMR.

Managers shall disclose all pertinent information regarding any and all regulatory findings and/or litigation in which their firms are involved.

Managers, consultants, custodians and any other vendors addressed in the Investment Policy guidelines shall report annually to the VPIC on their compliance with Regulation 2001—01, Standards of Conduct. *Such report shall detail all contact with VPIC members and staff (except the normal course of business, and shall include any and all gifts and gratuities, even those less than $10).*

Business Conduct

The VPIC believes that sound corporate governance and responsible corporate policies and practices lead to increased shareholder value.

The VPIC supports the adoption and effective implementation of policies and practices by corporations, investment managers and advisors for the responsible conduct of business and business relationships to protect the long-term investment interests of plan participants and beneficiaries. In addition, the VPIC expects that their vendors will support and adhere to such policies and practices.

The VPIC will respond accordingly when vendors are found to participate in illegal or unethical activities that have the potential to harm the plan and will monitor, through its pension consultant, all of its investment managers for any such activity. The pension consultant is expected to keep the VPIC apprised of allegations of illegal or unethical activities by investment managers by the VPIC and to recommend an appropriate response by the VPIC.

The VPIC will put vendors charged by a public authority of illegal or unethical activities on a watch list until a determination is made about whether the activities in question are substantiated and are grounds for termination or some other remedial step. All future contracts between the VPIC and a vendor will include notice of this policy.